

**STATE OF ILLINOIS
SECRETARY OF STATE
SECURITIES DEPARTMENT**

IN THE MATTER OF: JOHN H. HERZOG

FILE NO. 0500348

CONSENT ORDER OF CENSURE AND FINE

TO THE RESPONDENT: John H. Herzog
(CRD#: 1515035)
17213 Pointe Drive
Orland Park, Illinois 60467

C/o LaSalle Street Securities, L.L.C.
940 N. Industrial Drive
Elmhurst, Illinois 60126-1131

C/o AMIC
21104 Washington Parkway
Frankfort, Illinois 60423

C/o David A. Genelly
Attorney at Law
Vanasco Genelly & Miller
33 North LaSalle Street, Ste 2200
Chicago, Illinois 60602

WHEREAS, Respondent on the 9th day November of 2005 executed a certain Stipulation to Enter Consent Order of Censure and Fine (the "Stipulation"), which hereby is incorporated by reference herein.

WHEREAS, by means of the Stipulation, Respondent has admitted to the jurisdiction of the Secretary of State and service of the Notice of Hearing of the Secretary of State, Securities Department dated September 19, 2005 in this proceeding (the "Notice") and Respondent has consented to the entry of this Consent Order of Censure and Fine ("Consent Order").

WHEREAS, by means of the Stipulation, the Respondent acknowledged, without admitting or denying the truth thereof, that the following allegations contained in the Notice of Hearing shall be adopted as the Secretary of State's Findings of Fact:

1. At all relevant times, the Respondent was registered with the Secretary of State as a salesperson and as an investment advisor representative in the State of Illinois pursuant to Section 8 of the Act.
2. On June 22, 2005 NASD entered a Letter of Acceptance, Waiver and Consent and Waiver (AWC) submitted by the Respondent regarding File No. CE2050013 which sanctioned the Respondent as follows:
 - a. fine of \$59,300.22, which includes disgorgement of \$44,300.22; and
 - b. suspension from association with any NASD member firm in all capacities for ninety (90) days.
3. The AWC found:
 - a. This matter involves violations of NASD Rules in connection with market timing activity effected by the Respondent through LaSalle on behalf of a hedge fund customer of LaSalle. Market timing refers to the practice of short term buying and selling of mutual fund shares in order to exploit inefficiencies in the pricing of those shares. Market timing is accomplished either through purchases and redemptions of mutual fund shares from the mutual fund sub-accounts of variable annuities.
 - b. From September 2002 through December 2002, the Respondent facilitated deceptive practices regarding market timing in the sub-accounts of variable annuities for a hedge fund client that purported to manage money for wealthy individuals and corporate entities they established for that purpose (the "Hedge Fund Client"). The Hedge Fund Client used a number of different accounts to purchase variable annuity contracts from Hartford Life and Annuity Insurance Company ("Hartford Life"). The Respondent enabled the Hedge Fund Client to use these accounts to carry out frequent transfers among the sub-accounts of variable annuities without being detected by Hartford Life or by mutual fund managers, despite their attempts to enforce restrictions on market timing to protect the interests of long-term investors. The Respondent continued to process orders to sell variable annuity

policies for the Hedge Fund Client after receiving written notice from Hartford Life that it considered the client's trading strategy to be disruptive and contrary to the interests of long-term investors.

- c. In the spring of 2003, the Respondent received a one-time payment of \$44,300.22 through AMIC, his registered independent investment advisory firm, which it in turn had received from the Hedge Fund Client. The payment was to compensate the Respondent in part for commissions that were charged back to him after the underlying variable annuity contracts were surrendered by the Hedge Fund Client within the first year as well as for certain expenses incurred in connection with the variable annuity business of the Hedge Fund Client.
- d. The Respondent's conduct in facilitating the deceptive practice of the Hedge Fund Client regarding market timing was contrary to high standards of commercial honor and just and equitable principles of trade, and therefore violated NASD Conduct Rule 2110.

{Market Timing Within the Sub-Accounts of Variable Annuities}

- e. As described above, "market timing" is the practice of short term buying and selling of mutual fund shares to exploit inefficiencies in mutual fund pricing. Unlike securities listed on an exchange, the "net asset value" or NAV of a mutual fund currently is calculated only once per day, at 4:00 p.m. EST. This regimen for determining NAV provides market timers the opportunity to engage in arbitrage based on market information not reflected in that day's net asset value. To do this, market timers typically buy and sell shares in mutual funds on a short-term basis, realizing quick gains and then retreating to the previous market position. Market timing is not illegal per se. It can harm mutual fund shareholders, however, because it can dilute the value of their shares, by, among other things, requiring the fund to keep a larger percentage of highly liquid assets to cover the redemptions, or by increasing the transmission costs for the fund. Long-term fund investors may ultimately bear the burden of paying these costs. In addition, trading profits obtained by market timers can result in losses to mutual fund shareholders. Mutual funds generally maintain policies and procedures to detect and prevent market timing.

- f. Sub-accounts of variable annuities often provide an attractive investment vehicle for market timing organizations, because variable annuities offer a level of anonymity not available to market timers dealing with mutual funds. Investors in variable annuities do not initiate purchase and redemptions of shares directly with the mutual fund company; rather, investors in annuities are permitted to allocate invested funds among a variety of mutual fund "sub-accounts." Rather than purchasing and redeeming funds directly from the mutual fund company, investors in annuities instruct the insurance company to transfer funds from one sub-account to another. The insurance company, in turn, initiates and monitors purchases and redemption of mutual fund shares once per day on an "omnibus" basis for numerous clients. As result, mutual fund companies do not have direct access to the identities of individual investors who have requested transfers of funds among the sub-accounts, complicating the efforts of the mutual fund companies to detect excessive market timing by any given investor.
- g. To guard against the adverse impact of market timers on the long-term shareholders of sub-account mutual funds, insurance companies that sell variable annuities generally maintain policies and procedures to detect and prevent market timing. Moreover, the prospectuses that govern variable annuity contracts typically state that variable annuity products are not designed for market timing. For example, the prospectus governing the Hartford Life "Directors Access" annuity offered through LaSalle stated:

This Contract is not designed to serve as a vehicle for frequent trading in response to short-term fluctuations in the stock market. Any individual or legal entity that intends to engage in international arbitrage, utilize market timing practices or make frequent transfers to take advantage of inefficiencies in Fund pricing should not purchase this Contract. These abusive or disruptive transfers can have an adverse impact on management of a Fund, increase Fund expenses and affect Fund performance.

{The Respondent's Relationship with the Hedge Fund Client}

- h. In or about late spring 2002, the Respondent formed a relationship with the Hedge Fund Client. The trading strategy of the Hedge Fund Client included, in part, market timing in mutual funds within sub-accounts of variable annuities.

- i. The Respondent should have known in or before September 2002 that the Hedge Fund Client was engaged in market timing activities, and that it intended to open accounts for various corporate entities and individuals through the Respondent for the purpose of executing a market timing strategy within the sub-accounts of variable annuities. He knew at that time that the Hedge Fund Client was interested in purchasing annuities that did not impose surrender charges if closed within the first calendar year after the contract was opened. In June 2002, the Respondent, through his registered independent investment advisory firm, and the Hedge Fund Client entered into an agreement under which the Hedge Fund Client would reimburse the investment advisory firm for "the full amount of any charges incurred from surrendering of annuity contracts, if because of action taken by the insurer or by the request of the Hedge Fund Client."
- j. The Hedge Fund Client's accounts were transferred to the Respondent and LaSalle from another firm. Prior to that transfer, the registered representatives who handled the accounts told him that the firm was no longer able to do business with the Hedge Fund Client's accounts.
- k. The Respondent also knew that prospectuses that governed annuity products offered through LaSalle, including the Hartford Life Director Access annuities, stated that the relevant annuities were designed for long-term investors and were not designed for market timing.
- l. The Respondent received at least 13 letters from Hartford Life, on or before September 19, 2002, notifying him that market timing and excessive transfers among sub-accounts by the Hedge Fund Client were disruptive to the underlying funds, harmed long-term investors, and increased costs to the funds.
- m. Despite this information, the Respondent facilitated deceptive practices, as described below, regarding market timing, and continued to process orders to sell Hartford Life and other variable annuity products for the Hedge Fund Client while knowing that the Hedge Fund Client intended to engage in trading patterns that Hartford Life had previously stated would be disruptive and harmful.

- n. The Respondent also received a one-time payment of \$44,300.22 through AMIC, his registered independent investment advisory firm, which in turn had received from the Hedge Fund Client. The payment was to compensate the Respondent in part for commissions that were charged back to him after the underlying variable annuity contracts were surrendered by the Hedge Fund Client within the first year, as well as for certain expenses incurred in connection with the variable annuity business of the Hedge Fund Client.

{Hartford Life}

- o. During the relevant period, the prospectus for Hartford Life's "Director Access" variable annuities set forth a transfer policy that was "designed to protect Contract Owners from abusive or disruptive trading activity." The policy permitted twenty sub-account transfers per year placed by telephone, internet or facsimile. Any additional transfers in a calendar year could only be placed by U.S. mail or overnight delivery service. The prospectus further provided:

Regardless of the number of transfers you have made, we will monitor Sub-Account transfers and we may terminate your transfer privileges until your next Contract Anniversary if we determine that you are engaging in a pattern of transfers that is disadvantageous or potentially harmful to other Contract Owners.

The prospectus stated that Hartford Life would consider the dollar amount of the transfer, the total assets of the Funds involved, the number of transfers already completed in the current calendar quarter, and "whether the transfer is part of a pattern of transfer designed to take advantage of short term market fluctuations or market inefficiencies." The prospectus also stated that additional transfer restrictions could be placed on contracts funded with an initial deposit of \$1 million or more.

- p. Between August 2002 and December 2002, the Respondent arranged for sub-account transfers, on behalf of the Hedge Fund Client, in at least 25 Hartford Life "Director Access" annuities. Those annuities were held in the names of five different limited liability corporations managed by the Hedge Fund Client. Some of those contracts were initially funded at another firm and transferred to LaSalle. The annuitant on each contract was an individual the

Respondent knew or should have known to be employed by or associated with the Hedge Fund Client. Five of the contracts were funded with initial deposits of \$980,000, \$980,000, \$960,000, \$873,000, and \$867,000, thereby avoiding Hartford Life's additional transfer restrictions on contracts initially funded with \$1 million or more.

- q. On ten of the 25 annuity contracts, the Respondent received a written restriction letter from Hartford Life within two to seven weeks after the contract was initially funded. Four of the ten contracts were restricted after effecting ten to fourteen transfers in less than one month. Six additional contracts were restricted after making between six and eight transfers due to the dollar amount of the transfers and their effect on the fund's liquidity. Nonetheless, after Hartford Life notified the Respondent that it was exercising its contractual right to terminate transfer privileges on those contracts, on at least three occasions the Respondent submitted new applications to Hartford Life for the same product on behalf of the same business entities, sometimes listing another employee of the Hedge Fund Client as the annuitant, and sometimes using different corporate identities with different account numbers and tax ID numbers in an attempt to avoid detection as a market timer. In fact, annuitants were officers or employees of the Hedge Fund Client. This conduct was intended to deceive Hartford Life and allow the Hedge Fund Client to continue trading Hartford Life contracts, notwithstanding Hartford Life's efforts to stop that trading. As the Respondent knew, and as Hartford Life had stated in its prospectuses and restriction letters, the continued trading activity was harmful to Hartford Life's contract owners.
 - r. The Respondent's conduct as set forth above was contrary to high standards of commercial honor and just and equitable principles of trade, and therefore violated NASD Conduct Rule 2110.
4. Section 8.E(1)(j) of the Act provides, inter alia, that the registration of a salesperson and investment advisor representative may be revoked if the Secretary of State finds that such salesperson or investment advisor representative has been suspended by any self-regulatory organization registered under the Federal 1934 Act or the Federal 1974 Act arising from any fraudulent or deceptive act or a practice in violation of any fraudulent or deceptive act or a practice in violation of any rule, regulation or standard duly promulgated by the self-regulatory organization.

5. NASD is a self-regulatory organization as specified in Section 8.E(1)(j) of the Act.

WHEREAS, by means of the Stipulation Respondent has acknowledged, without admitting or denying the averments, that the following shall be adopted as the Secretary of State's Conclusion of Law:

By virtue of the foregoing, the Respondent's registration as a salesperson and as an investment advisor representative in the State of Illinois is subject to revocation pursuant to Section 8.E(1)(j) of the Act.

WHEREAS, by means of the Stipulation Respondent has acknowledged and agreed that he shall be censured.

WHEREAS, by means of the Stipulation Respondent has acknowledged and agreed that he shall be FINED Five Thousand dollars (\$5,000.00), to be paid by certified or cashier's check, made payable to the Secretary of State, Investors Education Fund.

WHEREAS, by means of the Stipulation Respondent has acknowledged and agreed that he shall be levied costs incurred during the investigation of this matter in the amount of Two Thousand Five Hundred dollars (\$2,500.00). Said amount is to be paid by certified or cashier's check, made payable to the Office of the Secretary of State, Investors Education Fund.

WHEREAS, by means of the Stipulation Respondent has acknowledged and agreed that he has submitted with the Stipulation a certified or cashier's check in the amount of Seven Thousand Five Hundred dollars (\$7,500.00). Said sum is allocated as follows: Five Thousand dollars (\$5,000.00) as a FINE; and Two Thousand Five Hundred dollars (\$2,500.00) to cover the costs incurred during the investigation of this matter. Said check has been made payable to the Office of the Secretary of State, Investors Education Fund.

WHEREAS, the Secretary of State, by and through his duly authorized representative, has determined that the matter related to the aforesaid formal hearing may be dismissed without further proceedings.

NOW THEREFORE IT SHALL BE AND IS HEREBY ORDER THAT:

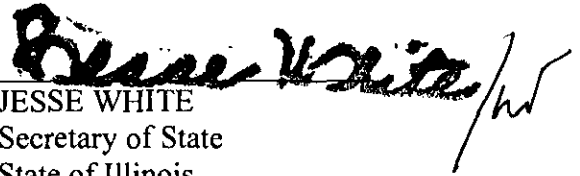
1. The Respondent is censured.

Consent Order of Censure and Fine

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2. The Respondent is FINED in the amount of Five Thousand dollars (\$5,000.00), payable to the Office of the Secretary of State, Investors Education Fund, and on November 9, 2005 has submitted Five Thousand dollars (\$5,000.00) in payment thereof.
3. The Respondent is levied costs of investigation in this matter in the amount of Two Thousand Five Hundred dollars (\$2,500.00), payable to the Office of the Secretary of State, Investors Education Fund, and on November 9, 2005 has submitted Two Thousand Five Hundred dollars (\$2,500.00) in payment thereof.
4. The formal hearing scheduled on this matter is hereby dismissed without further proceedings.

ENTERED: This 11-21 day of November 2005.


JESSE WHITE
Secretary of State
State of Illinois